



2.0 DEVELOPMENTS IN THE GLOBAL ECONOMY



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### Overview

The global economy suffered a serious financial crisis in 2008 which originated from the US subprime crisis that unfolded in 2007 and resulted into a credit crisis and disruptions of major financial institutions in the United States, Europe and the whole world economy.

The global financial crisis led to the collapse of commodity prices in 2008 as oil prices which reached record highs of US \$147 per barrel in July, fell significantly to US \$48 per barrel at the end of the year. In addition, copper prices declined to US \$2,902 from the record high of US \$8,985 per tonne in July 2008. Prices of other commodities such as fertilizer also followed similar trends.

Fuel and food prices reached historically high levels in the first half of the year and contributed significantly to inflationary pressures globally. These pressures were most felt by developing countries especially in Sub Saharan Africa (SSA) where inflation rose from 7.1% in 2007 to 11.7% in 2008. However, inflationary pressures were contained towards the end of the year due to the decline in global demand.

A number of advanced economies moved slowly into recession as credit conditions became tighter towards the end of 2008. This threatened a number of developing and emerging economies, as it had damaging effects on their domestic economies and adversely affected economic growth, inflation, the exchange rate and the terms of trade.

### Global Economic Performance

The global economic growth slowed down to 2.5% in 2008 from 3.7% in 2007 largely on account of the recession in the United States of America (USA), Euro area, Japan, United Kingdom and Canada (see Table 1). The recession was partly triggered by the turbulence in the financial markets of these economies associated with the USA subprime housing turmoil, the subsequent credit crunch and general loss of confidence in the financial systems (see Box 1).

Expansion in growth in emerging markets such as China, India, Russia and Brazil, however, mitigated the decline in economic growth experienced in advanced economies. The emerging economies mainly benefited from strong domestic demand and improved terms of trade from falling commodity prices during the second half of the year. For instance, oil prices declined by over 50% since their peak in July 2008, reflecting the global economic downturn.

#### Box 1: Global Financial Crisis

The genesis of the global economic crisis can be traced to the collapse of the sub-prime mortgage market in the United States of America (USA), which span over the period 2002-2006. During this period, lending to the household sector in the USA, was growing at a rate far beyond the country's economic growth. Poor underwriting standards for mortgage loans, weak regulation and supervision of the banking sector against many international banks with exposure to the sub-prime security backed financial assets characterized this period. Signs of the problem emerged as sub-prime borrowers were unable to service debt when interest rates rose, early in 2007 while loan defaults and foreclosures increased as demand for houses declined. Further, confidence among lending institutions waned, a situation, which led to a credit crunch. Financial institutions in the US (e.g. American International Group (AIG), Bank of America and Citigroup) short of liquidity, stopped lending to each other and were unable to provide credit to the private sector. Businesses scaled down operations (e.g. GM, Ford and Chrysler) or closed, reduced employment, and defaulted on their financial obligations. Growth in the USA slowed down and as the crisis spread to other advanced countries, the recession set-in. In response, the US Government and a number of Governments in the West put up stimulus measures, which included fiscal, interest rate and exchange rate adjustments. For instance, the US Government agreed a US \$17.4 billion bail-out for General Motors (GM), Chrysler and Ford to help starve-off imminent collapse. Further, US politicians announced a US \$700 billion deal to rescue America's financial system and end the credit crunch. The plan was prompted by a string of failures in large US financial institutions, including the government bail-out of insurance giant, AIG.

Immediate effects on the Zambian economy were withdrawals by foreign portfolio investors in Zambian Government and private securities, which in part, resulted in weakening of the Kwacha exchange rate. Further, the unfolding recession led to a sustained fall in commodity prices, such as, copper and oil.

Source: Various sources

Globally, inflation in 2008 rose, partly due to the surge in fuel and food prices. In advanced economies, inflation increased to 3.5% from 2.1% despite the decline in demand. Similarly, in emerging and developing economies, inflation rose to 9.2% from 6.4% the previous year. In other countries, there were inflation risks as higher commodity prices and continued pressure on local supply conditions affected wage demands and inflation expectations.

Higher commodity prices during the most part of 2008 resulted in the widening of the current account deficit in the advanced economies. This reflected increased current account surplus in the Commonwealth of Independent States (CIS) and the Middle-East which are net exporters of oil.

During 2008, a number of policy actions were implemented to address the root causes of the financial stress and to stimulate demand. For instance, the USA and the European Union instituted measures aimed at supporting key institutions, stabilising markets and bolstering confidence. These included government purchase of distressed assets, use of public funds to recapitalise banks and provide comprehensive guarantees, and a coordinated reduction in policy interest rates. In addition, some governments announced fiscal policy measures, such as tax relief, to support demand. Notwithstanding this, the financial markets remained volatile while the global economy slowed down remarkably underpinned by reduced consumption and investment in anticipation of prolonged financial crisis.

**Table 1: World Real GDP, Inflation and Current Account Positions, 2006-2008**

<i>(Annual % change unless otherwise Stated)</i>									
	Real GDP			Inflation (%)			Current Account Positions (% of GDP)		
	2006	2007	2008	2006	2007	2008	2006	2007	2008
World	5.1	3.7	2.5	n/a	n/a	n/a	n/a	n/a	n/a
<b>Advanced Economies</b>	3.0	2.7	1.3	2.4	2.1	3.5	-1.3	-0.9	-1.0
United States	2.8	2.0	1.1	2.4	2.2	3.6	-6.0	-5.3	-4.6
Euro area	2.8	2.6	1.0	2.2	2.1	3.5	0.3	0.2	-0.5
Japan	2.4	2.4	-0.3	0.3	0.8	1.6	3.9	4.8	4.0
<b>Commonwealth of Independent States</b>	8.2	8.6	6.0	9.4	9.7	15.6	7.5	4.4	5.5
Russia	7.4	8.1	6.2	9.7	9.0	14.0	9.5	5.9	6.5
Excluding Russia	10.2	9.7	5.4	8.9	11.6	19.7	1.1	-0.5	2.3
<b>Middle East</b>	5.7	5.9	6.4	7.0	10.6	15.8	21.1	18.4	22.9
<b>Latin America</b>	5.5	5.6	4.6	5.3	5.4	7.9	1.5	0.4	-0.8
<b>Emerging and Developing Economies</b>	7.9	8.3	6.3	5.4	6.4	9.2	12.3	10.5	
Africa	6.1	6.3	5.9	6.3	6.2	10.2	2.9	0.4	3.0
Sub-Saharan Africa	6.6	6.9	6.1	7.3	7.1	11.9	-0.3	-3.0	-0.7

Source: IMF: World Economic Outlook Update, November 2008, Economic Outlook, October 2008  
n/a = not applicable

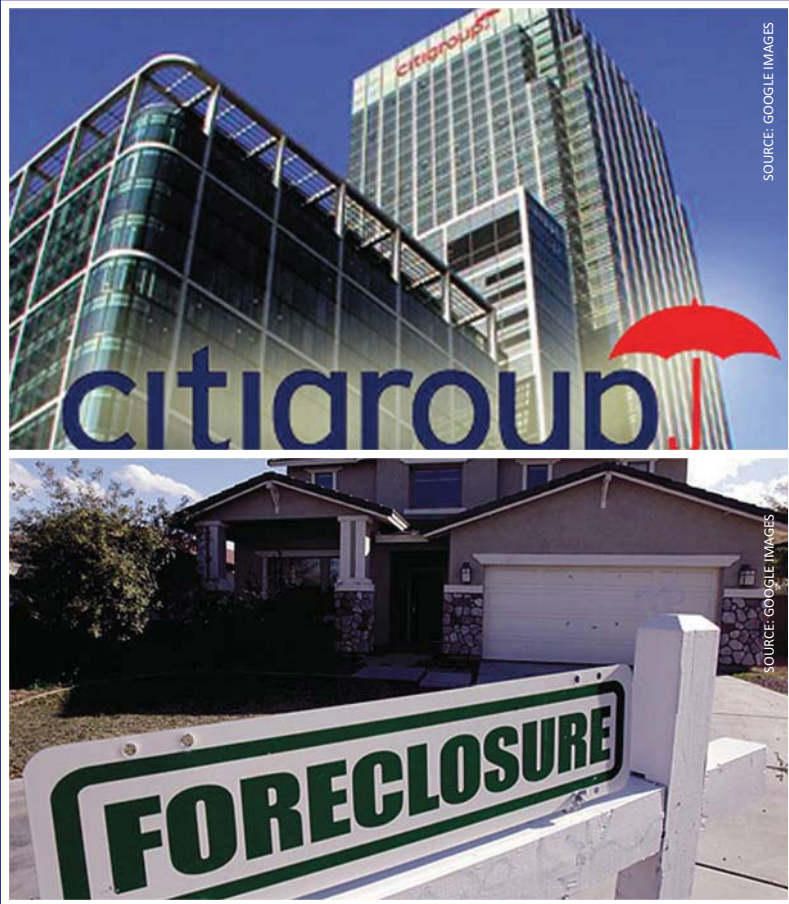
**Advanced Economies**

The real GDP growth in advanced countries slowed down to 1.3% in 2008 from 2.7% in 2007, as most economies were affected by the financial turmoil and high commodity prices, especially in the first half of the year. For instance, in the USA, consumer and business confidence was eroded that tightened credit conditions and amplified the housing mortgage problem. This resulted in the contraction of the USA economy, as precipitated by declining investment in the residential sector and in private consumption.

The American International Group (AIG) was one of the organisations at the centre of the financial crisis. AIG insured many of the securities that mortgages in America were resold under



Financial turmoil and high commodity prices, mainly in the first half of 2008, negatively affected the performance of the USA economy in particular and the rest of the world in general. Leading financial houses were not spared from the negative economic developments



Economic activity in Western Europe also slowed down largely due to high oil prices, tightening credit conditions, US slowdown and the appreciating euro. Growth in the Euro area was pulled down by tightening financial conditions and falling confidence. Japan's economy initially showed resilience, but was slowly affected by declining exports and deteriorating domestic demand towards the end of 2008.

In advanced economies, inflation increased to 3.5% from 2.1%, following high oil prices during the first half of the year despite the decline in demand. In response to inflation concerns, the European Central Bank increased its policy rate to 4.2% in July 2008. However, the USA Federal Reserve held the Federal Funds Rate at 2% on concerns of the impending recession.

The current account deficit of advanced economies slightly widened to 1.0% of GDP in 2008 from 0.9%, the previous year. Developments in the Euro area largely explained this outturn, as its current account balance fell to negative 0.5% from a positive balance of 0.2%. However, the US current account deficit narrowed to 4.6% of GDP in 2008 from 5.3% in 2007, following weakening growth relative to its trading partners and the sustained depreciation of the US dollar since 2002.

#### Emerging and Developing Economies

Growth in emerging and developing economies slowed down to 6.3% in 2008 from 8.3% in 2007, due to a decline in domestic demand and net exports. Commodity exporting economies benefited from high export prices and maintained positive growth. By contrast, countries with strong trade links with the US and Europe experienced a slow down and those that relied on bank-related or portfolio inflows to finance large current account deficits were adversely affected by an abrupt tightening of external financing.

Inflation in emerging and developing economies was recorded at 9.2% in 2008 from 6.4% in 2007, with a number of countries experiencing double digit levels. This largely reflected rising food prices, which constitute a significant weight in the consumer price index. In response, most central banks raised interest rates while others increased reserve requirements. However, most of these steps were reversed towards the end of 2008 in response to the intense liquidity strains related to the financial crisis.

### Commonwealth of Independent States (CIS)

Economic growth in the CIS region continued to expand due to strong domestic demand that was boosted by terms of trade gains in most countries and expansionary macroeconomic policies. Nonetheless, real GDP growth slowed down to 6.0% in 2008 from 8.6% in 2007 owing to weakening external demand and the effects of the unfolding global financial melt-down. Inflation in the region increased to 15.6% in 2008 from 9.7% in 2007 on account of high world prices of food and fuel. In the external sector, high international commodity prices continued to boost trade balances in net commodity exporters, while net commodity importers saw a marked weakening in their external position.

### Latin America

Latin American economies faced a combination of factors, including falling equity prices, high inflation and difficult external conditions, notably exchange rate pressures and lower export prices. Consequently, economic growth slowed down to 4.6% in 2008 from 5.6% in 2007 while inflation at 7.9% was the highest in 5 years. In response to rising inflation, central banks raised policy interest rates. External positions of countries in Latin America were generally favourable, although the turbulence in the global economy eroded the cushions that were built over the years. The region's current account balance moved into deficit of 0.8% of GDP in 2008 after being in surplus since 2003.

### Middle East

In the Middle East, economic growth at 6.4%, remained robust in 2008 supported by growing domestic demand. However, inflation surged to 15.8% in 2008 from 10.6% in 2007 due to domestic demand pressures. Current account developments differed widely between oil and non-oil exporters. While the former recorded large growing surpluses, the latter experienced widening deficits in response to rising import costs.

### African Economies

Despite the financial turmoil, coupled with high energy and food prices, growth of African economies remained strong at 5.9% in 2008 compared with 6.3% in 2007 (see Table 2). Sub-Saharan Africa (SSA) economies expanded by 6.1% in 2008 compared with 6.9%, as many of these countries benefited from terms of trade gains arising from the surge in commodity prices. The slowing down in growth for the region reflected slower than expected growth in global demand and slowing capital inflows. In South Africa, SSA's largest economy, electricity shortages early in 2008 and the need to raise policy interest rates to contain inflation contributed to the slow growth in 2008.

Inflation in Africa increased to 10.2% in 2008 from 6.2% in 2007. Similarly, in SSA, inflation rose to 11.7% from 7.1%. This outturn was attributed to most SSA countries experiencing rising food prices, particularly in the first half of 2008, which in turn was principally driven by high grain prices on the international market. In addition, international oil prices rose sharply to a record high of US \$147 per barrel, contributing to increased inflationary pressures in most countries.

African economies recorded an improvement in the current account surplus to 3.0% of GDP in 2008 from 0.4% in 2007, owing to rising commodity prices, particularly during the first half of the year. For SSA, the current account deficit narrowed to 0.7% of GDP from 3.0%.

**Table 2: Selected African Countries GDP and Inflation, 2006-2008**

*(Annual % change unless otherwise stated)*

	Real GDP (%)			Inflation (%)		
	2006	2007	2008	2006	2007	2008
Africa	6.1	6.3	5.9	6.3	6.2	10.2
Angola	18.6	21.1	16.0	13.3	12.2	12.1
Ghana	6.4	6.3	6.5	10.2	10.7	16.8
Kenya	6.4	7.0	3.3	14.5	9.8	25.0
Nigeria	6.2	5.9	6.2	8.6	5.5	11.0
South Africa	5.4	5.1	3.8	4.7	7.1	11.8
Tanzania	6.7	7.1	7.5	7.3	7.0	9.2
Uganda	10.8	7.9	9.8	6.6	6.8	7.3
Zambia	6.2	6.2	6.0	8.2	8.9	16.6
Sub-Saharan Africa	6.6	6.9	6.1	7.3	7.1	11.9

Source: IMF: World Economic Outlook, October 2008, CSO 2009